CGAP Phase III Strategy
2003 - 2008

JANUARY 2003

Building financial systems that work for the poor

Photographs, front cover:

(background, then left to right): Two women holding money, Cambodia (Tim Hall/Getty Images); Women removing fish traps, Okavango River, Botswana (Peter Johnson/Getty Images); Farmer on carriage, Egypt (Hisham F. Ibrahim/Getty Images); Woman selling flowers at market stand, Ecuador (Corbis); Bulls pulling carts on a rainy day, India (Corbis).

Photographs, back cover

(background, then left to right): Outdoor market, Bombay, India (Eyewire Collection/Getty Images); People making food, Burkina Faso (©1993, The World Bank Photo Library/Curt Carnemark); Woman weaving, Kenya (© The World Bank Photo Library); Man with water buffalo cart, Philippines (©1975, The World Bank Photo Library/Edwin G. Huffman).

CGAP

Consultative Group to Assist the Poor
c/o The World Bank
1818 H Street, N.W.
Room Q4-400
Washington, D.C. 20433

Tel: (202) 473-9594
Fax: (202) 522-3744
email: cgap@worldbank.org.
Web: www.cgap.org

Phase III Strategy
2003 - 2008

Building financial systems that work for the poor

FOREWORD

This Strategy Paper sets out the broad directions and priorities that will guide the third phase (2003-2008) of CGAP, together with plans for implementing the strategy. The strategy was prepared on the basis of extensive discussions between the Consultative Group of member donors, the Policy Advisory Group, the CGAP Secretariat, and a large number of other leaders in the microfinance industry through vision statements for the microfinance industry and other mechanisms. A strategic outline prepared by the Executive Committee and the Secretariat set the framework for this document. As a five-year strategy, it will be complemented by detailed annual workplans of proposed activities to be submitted each year to the Executive Committee. Plans for the future institutionalization of CGAP or its activities beyond 2008 will be considered in 2005.

This paper defines the role of microfinance in the development agenda and discusses the key challenges of expanding financial services to the poor on a much larger and more sustainable scale. The paper proposes ways in which the donor community – individually as well as collectively – can best promote the development of financial services to the poor and, specifically, how CGAP as a donor consortium can assist donors in this effort.

INTRODUCTION

The Vision for Microfinance in 2008

With an estimated untapped market of nearly a billion poor people, microfinance now stands at a crucial crossroad. Successful microfinance NGOs have proved that financial services can be an effective and powerful instrument for poverty reduction by enhancing the ability of poor people to increase incomes, build assets, and reduce their vulnerability in times of economic stress. There is greater consensus than ever before about what is needed to make microfinance sustainable. Yet with most poor people still lacking access to basic financial services, microfinance has yet to reach its full potential.

Over the next decade, microfinance will either realize its vast potential for improving the lives of large numbers of the poor – or it will remain an unfulfilled promise. Much depends on the extent to which the international development and financial communities can partner with social entrepreneurs and governments in developing countries to develop financial systems for the poor that are far broader than those that currently exist. Of course, macroeconomic policies and individual sector improvements will need to underpin the development of such financial systems: finance alone is clearly not enough.

This new vision is a world in which diverse poor people enjoy permanent access to a wide range of financial services, delivered through a variety of convenient mechanisms by different types of institutions. The concept of financial services to the poor will no longer be dominated by microcredit, but will recognize the importance of such other services as savings, payment services, and insurance. Providers will include not only non-governmental microfinance institutions (MFIs), but also savings and credit cooperatives, commercial banks, community finance institutions, consumer credit companies, insurance companies, and other financial institutions.

Increasing competition among products and institutions will result in greater efficiency, benefiting both financial institutions and clients. Advances in technology will lead to reduced transaction costs, enabling volumes to grow and marginal costs to decline. New technologies will also improve client information and asset and liability management, reducing risk and thus costs. In this vision, national policymakers understand that financial systems can and should work for all levels of society, especially for the poor who constitute the overwhelming majority of their populations.

The overarching goal of CGAP in this vision is to support the development of financial systems that work for the poor. This approach requires that we remove the walls – real and imaginary – that separate the microfinance community from the much broader world of financial systems, markets, and development. It requires that we refuse to accept a status quo in which it is considered normal for a country's financial system to serve only a tiny minority of its population, while the vast majority remains outside the system. It requires recognizing the vast differences between poor people and understanding that very different delivery organizations with varied but complementary objectives will be needed to serve them all. Several successful institutions have proved that even the very poor can be reached sustainably.

This vision embraces institutions that are motivated to provide sustainable financial services to the poor because it makes economic sense, as well as those driven by the objectives of poverty alleviation and/or job creation. Encouraging a more diverse range of organizations with different objectives, and different needs for subsidy, will enable outreach to a broader range of poor clients, from growing urban microenterprises to very poor rural households.

This transformation of perspective is urgent, as the growth of poverty and unrealized human potential outpaces the incremental growth of microfinance. This transformation is also within our reach because many of the necessary elements needed to scale up microfinance are already in place. Banks and other institutions with nationwide distribution systems are beginning to take interest in reaching poorer clients. A great deal of the knowledge about the requirements of sustainable microfinance already exists. Advances in information technology have never been so promising to lower the cost and risk of delivery mechanisms. The challenge before us is to mobilize this knowledge and apply it on a much vaster scale.

Before tackling this enormous challenge, however, it is important to address the basic question of what microfinance is, why it is important, and how it contributes to development.

What is Microfinance?

As recently as a few years ago, the term "microfinance" was easily understood: a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to microentrepreneurs (or potential microentrepreneurs). The vision was that microenterprises of clients would grow, increasing their incomes and sometimes creating employment, lifting the poor out of poverty. The promise of sustainability meant that microfinance could leverage relatively scarce donor funding by attracting much larger pools of private capital, thus expanding outreach to massive numbers of the poor. The non-governmental organizations (NGOs) that pioneered this methodology and have provided most of the microloans to date would grow, become independent from donors, and possibly transform into banks for the poor, without losing their social mission.

Today the picture has become far less clear, the storyline more nuanced, and the boundary between microfinance and other financial services blurred. We recognize that the microfinance world as it has been narrowly defined is but a small segment of the universe of financial services to poor people. Traditional microfinance has encountered several core challenges to a number of its basic premises:

- Not all the poor run growing microenterprises, but all poor people need, use, and benefit from different kinds of financial services. In fact, poor people are extremely diverse and their needs vary widely with their circumstances.
- Supply-driven credit methodologies have reached a relatively narrow band of potential clients within the spectrum of the poor, often leaving behind both extremely poor and remote clients, and the less-poor with larger enterprises.
- The types of financial services needed by poor people extend far beyond working capital loans, encompassing an array of savings, credit, insurance, and money transfer services. Convenient, safe and secure deposit services are a particularly crucial need.
- NGOs, while crucial for experimenting with new models and conducting research and development, face challenges in governance, legal frameworks, and cost structures. More importantly, they generally have not reached massive scale, or independence from donors (although there are major exceptions to this rule).
- While they are few, several successful microfinance NGOs have demonstrated that it is possible to achieve financial self-sustainability while reaching the very poor with extremely small loan sizes, even the very poor in sparsely populated areas.
- Institutions with large existing infrastructures, such as commercial and state-owned banks, credit union networks, financial cooperatives, and even retail chains, may offer a significant, if challenging, "answer" to the problem of scaling up financial services for the poor.

These lessons learned point to an expanded view of our task: microfinance is about diverse institutions providing massive, permanent access to a broad range of financial services for a broad range of clients.

The Role of Microfinance in Reducing Poverty

At the core of microfinance is a fundamental belief that access to financial services protects and empowers the poor by mitigating them from risks and giving them choices. Financial services help the poor cope with a common feature of their lives: vulnerability. Whether they save or borrow, evidence shows that when poor people have access to financial services in the absence of emergency conditions, they choose to invest their savings or loans in a wide range of assets. These "assets" can be sending children to school, buying better medicines and more nutritious food, fixing a leaky roof, meeting social and cultural obligations like paying for and funerals, as well as building income-generating potential by investing in their enterprises.

The multiple roles of financial services for the poor parallel the multiple dimensions of poverty captured in the Millennium Development Goals (MDGs) (see box below). The MDGs have galvanized the development community around measurable and concrete indicators of poverty reduction.

Financial services put power into the hands of the poor to pursue their own strategies for building human, physical, economic and social capital to escape poverty. And because microfinance services can be delivered sustainably within relatively short periods of time, benefits can be delivered on a permanent basis, well beyond the duration of donor or government programs that rely on continuous subsidies.

Far from being a narrowly defined, specialized field occupying a small corner of development thinking

How does Microfinance Contribute to the Millennium Development Goals (MDGs)?

A review of microfinance literature points to several specific conclusions about the impact of microfinance on poverty reduction and several other MDGs:

Eradicate extreme poverty and hunger. Extensive evidence demonstrates that microfinance helps reduce poverty through increases in income, allowing the poor to build assets and reduce their vulnerability.

Achieve universal education. Households that have access to microfinance spend more on education than non-client households. Improvements in school attendance and the provision of educational materials are widely reported in microfinance households. Participation in credit and savings programs has enabled many families to send several children at a time to school, and has reduced drop-out rates in higher primary grades.

Promote gender equality and women's empowerment. Microfinance clients are overwhelmingly female. Microfinance has been widely credited for empowering women by increasing their contribution to household income, the value of their assets, and control over decisions that affect their lives.

Reduce child mortality, improve maternal health, and combat disease. Microfinance contributes to improved nutrition, housing, and health, especially among women clients.

and practice, microfinance is an important foundation for poverty alleviation and the wider development agenda. It supports other development efforts and can make a significant difference in the way poor people address those development problems on their own terms.

Microfinance and Financial Sector Deepening

Until now, microfinance has largely developed outside the realm of the formal financial sector on a separate track that seldom interacts with established financial actors. When governments and donors address financial sector issues, broad concerns such as banking sector reform, capital market development, and corporate governance are generally at the top of their agenda, not microfinance. For its part, the microfinance community of practitioners, donors, and technical experts has argued, perhaps too convincingly, in favor of microfinance as a highly specialized sector that needs separate standards, techniques and/or legal frameworks to be effective. These arguments made sense at the time when the need to professionalize microfinance into a more business-like activity became apparent. However, the efforts to make microfinance something separate have also served to isolate it as a marginal sector disconnected from the broader financial system.

It is becoming increasingly apparent that large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into the overall financial system. This means that microfinance, or financial services for the poor, becomes the lower end of the entire financial sector, opening up access and markets to increasingly poor and geographically remote clients. It means achieving financial sustainability not through high interest rates alone, but by leveraging technology and streamlining business processes to increase cost efficiency in the face of competition. It means attracting new players and new sources of commercial and quasi-commercial debt and equity capital. It means promoting transparency that allows the outside world to understand and judge the performance of microfinance vis-à-vis other financial and non-financial services and other development interventions. It means governmental policies that promote financial sector deepening and expansion. It means seeing microfinance as greater than microcredit and microenterprises -- as financial services for the poor.

It also means ensuring that the social values-driven mission of microfinance is not un-intentionally compromised as a result of this integration.

The “financial systems approach” to microfinance has generally meant a focus on one dimension of this vision – the sustainability and formalization of microfinance institutions. True, the paucity of strong retail institutions remains the principal bottleneck to meeting the massive demand for financial services among the poor. However, just as there is wide diversity in poor clients and their needs and circumstances, so must there be a wide range of service providers motivated by varied objectives. This vision upholds the essential principles of financial sustainability in order to allow for growth, and it calls for acknowledgement and clarification of the role of subsidies in institutions and support organizations that are doing work that merits subsidy.

Current Actors in the Microfinance System

Over the last 30 years, the microfinance industry has grown to encompass many types of actors with different objectives, roles, and comparative advantages. Clearly, no single organization has the means or the capacity to achieve the expanded vision of microfinance on its own. Developing financial systems that work for the poor will require improved dialogue, coordination, and partnership among these different actors, as well as building better linkages with other development sectors.

Providers of financial services to the poor. Microfinance suppliers can be divided into three broad categories: (i) traditional and informal providers, such as moneylenders, pawn shops, and rotating savings and credit associations (ROSCAs); (ii) formal unlicensed institutions such as microfinance NGOs; and (iii) licensed financial intermediaries, including commercial and state-owned banks, credit unions, community finance institutions, consumer credit companies, and finance companies. Understanding the market penetration, growth, and performance of these various delivery models is an important part of assessing how the financial system as a whole works for the poor. Better understanding will reveal where the gaps are and what can be done to meet the needs of those who are not being served.

Networks. Intermediary organizations have, and will continue, to play a critical role in microfinance. Such organizations include national associations of microfinance institutions, regional or global networks of MFIs or credit unions, and even some investment funds that provide governance and technical assistance to MFIs.

Networks serve several crucial functions in expanding the delivery of financial services to the poor. First, they are an important voice in policy and regulatory change, both within countries and across regions. Second, they can be an effective means of intermediating both capital and technical services between donor agencies and service providers on the ground. Third, they are a potent force for improving the performance of their members through peer learning, information exchange, and mutual accountability. Fourth, networks that provide funding to members, such as through investment funds, sometimes fulfill a governance function that is more effective and closer to true commercial governance than what donors provide.

Donors. Virtually all donors, including private, local, bilateral, and multilateral donors, as well as local and international NGOs, support microfinance activities in some way: through grants, subsidized loans, guarantees, or technical assistance. The approach of donors – and the requirements they set for microfinance institutions to access their funds – can significantly affect the development of the sector. Even as some financial service institutions "graduate" to commercial funding, there will always be a role for donors to subsidize development work that is not commercially viable, either because of the risk or the cost. Donor subsidies, for example, can motivate new financial institutions to enter the market by defraying development and technical assistance costs. The role of subsidies in microfinance is important, but needs to be more clearly defined, as does the role of donors vis-à-vis other, more commercial funding sources.

Private Investors. There is widespread recognition that in order to reach scale, microfinance needs to move from dependence on donor funding to reliance on more abundant commercial funding and domestic savings. Most private capital that supports microfinance takes the form of institutional deposits attracted by licensed institutions. While private capital still represents only a small fraction of total funding, a range of private funders/investors –from commercial banks to socially responsible investors – are becoming increasingly interested in microfinance as more microfinance institutions demonstrate the profitability of banking for the poor. An important requirement for attracting greater private resources into microfinance is reliable information on the performance of financial institutions serving the poor. Another important requirement is mechanisms that can better match the demand for funds on the part of well-performing or high-potential institutions with the supply of available funds.

Governments. Depending on their approach, governments can either undermine or encourage the development of microfinance. In general, the government's role in microfinance should be to maintain or create an enabling environment that permits the growth of financial services for the poor and the integration of the poor in the broader economy. Governments can do this by addressing broad legal and regulatory constraints – such as cumbersome business registration procedures, corruption, or inflexible property rights laws – which, while not specific to the poor, may place an undue burden on them. An important element of this strategy is a regulatory framework that allows a wide array of financial intermediaries to serve the poor. Interest rate ceilings have to be relaxed or removed so that microlenders can cover their costs. Licensing rules need to be adjusted so that financially solid institutions can fund their lending activities with deposits from the public.

Governments should get out of the business of directly providing financial services to the poor, eliminating subsidized and inefficient lending programs that foster a culture of non-repayment on the part of clients and undermine good microfinance institutions. Depending on the size of the microfinance sector, special attention should be paid to building the capacity of bank regulators to evaluate, monitor, and supervise microfinance institutions in a way that ensures the overall soundness of the sector without stifling its growth.

Technical Service Providers. As microfinance has evolved, a private industry of service providers to support microfinance institutions has come into being. This service industry encompasses technical advisers, audit firms, credit bureaus, rating agencies, trainers or training institutes, technology and information systems specialists. The lack of local capacity to provide these services has resulted in overreliance on international expertise and thus high costs for these services. Building both the market for these services and the local human resource base to meet market demand is a key condition for the development of a sustainable microfinance industry.

CGAP. CGAP operates in partnership with many actors in this varied landscape through its operating arm, the CGAP Secretariat. CGAP is a resource center for donors and the microfinance industry as a whole, serving as an information clearinghouse, convening platform, knowledge center, and standard setter. Our comparative advantage in promoting financial services for the poor is based on our multi-donor platform, our ability to influence key issues in microfinance through collective consensus, our relative objectivity and our flexibility to respond to new opportunities and challenges.

Background on CGAP I and II

Compelled by the enormous potential of microfinance to evolve into a full-fledged financial industry serving the poor, nine leading donors and practitioners formed CGAP in 1995 to develop and share best practices, set standards, and develop tools and models. Over time, CGAP has become a recognized center of excellence, providing services and information to a wide array of industry actors engaged in building the microfinance industry. CGAP was originally established as a three-year program with a mission to increase poor people's access to financial services from sustainable institutions. In June 1998, CGAP was renewed for an additional five years and has now grown to 29 members, including bilateral and multilateral agencies, as well as private foundations. CGAP II focused on institution-building, poverty alleviation, commercialization, policy and regulation, and donor mainstreaming.

Since its inception, CGAP has played a pivotal role in developing a common language for the microfinance industry, catalyzing the movement towards best practice performance standards, and building consensus among its many and varied stakeholders. According to the recent external evaluation of CGAP II, “CGAP’s work was central to the development of the microfinance industry during Phase II. The technical capability of the Secretariat was at a very high level throughout the period, and its staff members were respected throughout the industry for their vision and leadership. The tools and reports produced by the Secretariat were consistently excellent. CGAP as a whole was also successful in this regard, with Member Donors continuing to provide leadership in promoting sustainability of the industry." Based on the positive evaluation and the demand of its stakeholders, CGAP will be extended for an additional five years (Phase III, 2003–2008).

PHASE III STRATEGY

CGAP is a consortium of donors working together to build sustainable financial services for the poor. The mission of CGAP III is to expand and to accelerate their access to a broad range of convenient and sustainable financial services. We believe that access to financial services is an essential building block for poverty alleviation and economic development, and that financial services for the poor must be integrated into the financial system of every country. To this end, the objective of CGAP in Phase III will be to help build financial systems that serve poor people with very different needs.

The work of CGAP in Phase III will center on the following four strategic priorities: (i) fostering a diversity of financial institutions that serve the poor; (ii) facilitating the poor's access to a wide range of flexible, convenient financial services; (iii) improving the availability and quality of information on the performance of microfinance institutions and, (iv) promoting a sound policy and legal framework for microfinance. CGAP will work in each of these four strategic areas by providing technical assistance, developing and setting standards, advancing knowledge and information sharing, and offering training and capacity building services together with other actors.

Partnership is essential to successfully leverage CGAP's and others' efforts and resources. In everything it does, CGAP operates in partnership with its member donors, MFIs, and other stakeholders in microfinance. In some partnerships, CGAP works jointly with others to develop technical tools or case studies. In others, it acts as a platform for dissemination. In many cases, CGAP aims to incubate an idea, test it, and, pending positive results, spin it off to others in the industry. In all cases, consultations with stakeholders is extensive. CGAP will continue to be selective in what it does, drawing on the work of others wherever possible.

CGAP serves as a neutral convening platform for the industry as a whole, facilitating dialogue and interaction between different sets of actors and players. At the same time, the CGAP Secretariat or the CGAP system as a whole can also use its position to take firm public positions on certain issues, such as standards or policies.

Promoting Institutional Diversity

Institutional diversity means that a variety of institutions will provide financial services to the poor. These institutions will have different organizational objectives, different methodologies and approaches, and serve different kinds of poor people. With the exception of a few countries, microfinance has so far failed to reach massive scale (with notable exceptions such as Bangladesh, where microfinance has reached significant numbers of poor households). This drives an urgent need to explore and deploy new delivery mechanisms to complement existing strong MFIs. Using different types of institutions to provide financial services to the poor will allow financial systems to reach poorer clients, those living in remote areas, and greater numbers of urban clients. Institutional diversity will also allow microfinance to serve clients whose growing enterprises require greater funding than that traditionally provided by microfinance institutions.

The strong NGOs that have built the microfinance industry to where it is today must continue to be strengthened and their successes replicated wherever possible. However, in some countries, reaching significant scale will require moving beyond the NGO model and opportunistically tapping into a few selected large banking and financial institutions that have extensive distribution networks already in place in poor neighborhoods and villages. With their large regional and national networks, credit unions and financial cooperatives are already a significant institutional channel for delivering financial services to poor and low-income populations. Despite their troubled history, state banks and rural banks are another distribution channel that needs to be considered to identify those few that have the potential to do more, particularly given their far-reaching infrastructure and mission to serve the poor. Consumer credit companies are already providing salaried employees as well as microenterprises with financial products and, despite serious problems in several countries, may offer potential to better serve the poor. Experiments with alternative delivery mechanisms such as post offices, supermarkets, beverage suppliers, and other models have already begun and may offer additional prospects for reaching truly large numbers.

To profit-maximizing organizations, microfinance can be an attractive debt business where downside protection is the driver, but it is generally less attractive as an equity business where upside profit potential is the driver. Thus, while many commercial banks are lending to NGO/MFIs, few are likely to see microfinance as a strategically compelling equity investment. That said, in some circumstances, microfinance can offer an attractive way for profit-maximizing commercial and retail banks to diversify risk, leverage under-utilized branch infrastructure, tap new markets when under competitive pressure and enhance their image. In other cases, franchising and other partnership arrangements can enable an MFI and a commercial bank to best exploit one another's competitive advantages.

Some of these organizations, and others like them, have potential to be better leveraged to serve the poor populations in their countries, reaching unserved markets and complementing the work of successful or promising MFIs. However, a rare combination of political reform, technical know-how, and management commitment and expertise will have to be in place for sustainable microfinance to prosper within these organizations.

Mapping of financial services for the poor. The world knows little about what services poor people receive from which institutions. Engaging the entire spectrum of financial service providers to the poor will involve capturing information on a vast range of financial organizations that operate in a universe far greater than that of the relatively well-delineated world of microfinance. To build a financial sector that is more accessible to the poor, we need to have a baseline estimate of the actual number of poor people receiving financial services from different sources so that we can monitor progress against that baseline. CGAP will focus first and foremost on a stock-taking exercise. This exercise, to be carried out in partnership with CGAP donors and other stakeholders, will give the microfinance community a better, but no doubt still incomplete, picture of the number of poor clients accessing financial services through various providers such as credit unions and cooperatives, banks, NGOs, and consumer credit companies.

Advancing industry knowledge. CGAP's most significant contribution to exploring alternative means of delivering financial services to the poor will be to serve as a research and development resource. In parallel to the mapping of microfinance providers, CGAP plans to engage in action research on different models that promise larger-scale coverage of different client groups in more cost-effective ways. Through research and active prospecting, we will provide donors with an inventory and assessment of different innovations taking place in the sector, the conditions needed to make them succeed, and the timeframe required to make such activities sustainable. This research will include analyzing the success stories of NGO MFIs such as ASA and BRAC to better understand factors leading to their scale and efficiency. In addition, CGAP will work with member donors to build on this knowledge to develop guidelines for how and when to support alternative types of institutions.

Providing technical advice. CGAP will seek opportunities to provide or arrange for strategic advice and technical assistance to existing financial organizations that are developing new business lines in varied financial services for the poor. In some cases, these organizations will be entirely new to the microfinance field, but may possess significant distribution infrastructures that might be better leveraged to provide services to the poor. CGAP plans to take this approach specifically in large countries with relatively underdeveloped traditional microfinance sectors where experimentation with existing or new delivery channels could have a major impact. This work is likely to entail substantial human resource costs (CGAP staff, plus local and international technical services) and will be carried out in collaboration with other service organizations.

Raising capital efficiently and effectively. Lack of access to capital is a constraint for some promising MFIs with potential for significant scale. Often, the financing required is a combination of instruments, such as donor grants for skills development or administrative systems and loans for portfolio expansion. CGAP will continue to encourage donors to utilize its Appraisal and Monitoring Service in order to bring the right mix of funding instruments more efficiently and effectively for those strong MFIs for whom capital is a constraint.

Working with networks. Global and local networks of microfinance institutions, investment funds, and other groupings of financial service providers are providing critical services in microfinance. These organizations vary from networks of MFIs united by a common mission to organizations linked by a common governance structure to investment funds that provide technical assistance. Their roles could include reliable intermediation of donor funds and quasi-private sector funds (both for the capitalization of members and as support for network-level services), the provision of technical services to and amongst members, and governance oversight.

CGAP will work in partnership with networks on policy issues at national and global levels, as well as to promote industry standards, transparency, and dissemination of good practices. CGAP can also play an important role in encouraging the differentiation and strengthening of these intermediary organizations by reinforcing the different roles they play in a rapidly evolving industry. Increased donor and private support for networks will require frameworks for evaluating the roles and performance of these organizations managing investment funds, providing technical services, and fulfilling governance functions.

Promoting Diverse Financial Services to a Broad Range of Clients

There is enormous demographic diversity amongst the client group we call the poor. The poor can include factory workers in middle-income formal economies as well as landless laborers in sparsely populated agricultural economies. Some poor regions have problems of aging populations, while others have exploding populations that need to be brought into the formal political economy. Wars and natural disasters have left some poor people rebuilding economic lives from nothing, while others may have seen disease fundamentally alter their households' means of generating income. Some poor people are employees, some are employers. Some have growing businesses, others live off of subsistence activities.

Great differences in circumstances mean that poor people need different kinds of financial services. These services encompass planning for future household expenditures, accessing funds in emergencies, protection against risk, receiving funds sent by relatives abroad, and investing in production inputs for an enterprise or farm. As more players enter the market and competition increases, microfinance will inevitably move away from the supply-led approach that applied a narrow range of lending methodologies to a wide range of contexts, towards a demand-driven, client-oriented approach.

Microfinance will no longer principally mean microcredit, but many financial services, including various loan products, savings, insurance, and cash transfers. Differentiated products should translate into broadened outreach, especially downward to very poor clients but also upward to growing small enterprise clients, making microfinance accessible to different levels of the poor. By offering a wider range of financial services, institutions will become more stable and sustainable through portfolio diversification, greater client loyalty and retention, and fund mobilization.

Building industry knowledge. In recent years, there has been marked and welcome attention paid to savings, insurance, and other financial services for the poor beyond microcredit. Given that many others are working actively in this area and are closer to the field, CGAP's role will center on building industry knowledge about new product innovations, the contexts in which they are taking place, and the success factors that make them most effective – both in terms of improving the lives of the poor and achieving sustainability. In particular, CGAP will focus on better understanding and documenting successful cases of savings mobilization to ensure that this activity does not remain the "forgotten half" of microfinance. CGAP will also continue to work with donors and other stakeholders to develop standards and guidelines on non-lending products such as savings and insurance.

Improving linkages between financial and non-financial programs. Evidence shows that microfinance has greater impact on the poorer and more disadvantaged when it is linked with or preceded by complementary services. Given the proliferation of hybrid programs in which financial services for the poor are combined with non-financial services such as education or health, there is an urgent need for guidelines on including microfinance in multi-sector projects. In some cases, such combinations have shown positive results, but in far more cases it is necessary to de-link or better sequence financial and non-financial services. For instance, new segments of very poor clients who have been excluded from financial services can graduate into microfinance by promoting better linkages between microfinance and social safety net programs. Experimentation with programs such as Bangladesh's Income Generation for Vulnerable Groups (IGVG) that help graduate extremely the poor into future microfinance clients should be encouraged.

CGAP will support the development of linkages between microfinance and safety net programs by facilitating dialogue and partnerships between the microfinance community and other development sectors and programs involved in poverty alleviation. CGAP will also provide technical and design advice and funding, together with its donors, to underwrite experimental linkage programs.

Incubating new models. CGAP will also promote product diversification by providing, either directly or in partnership, strategic advice, technical assistance and/or seed funding to various financial service providers that are testing new products, particularly in extremely challenging environments or among vulnerable populations. Examples might include experiments with money transfers systems or mobile deposit-taking services. This work would feed into the knowledge-building agenda as CGAP helps test innovations that offer workable models for the industry that can be adapted by other practitioners and supported by donors and private investors. To this effect, CGAP will continue, through its Appraisal and Monitoring Service, to identify and coordinate the evaluation of promising institutions or models and to mobilize joint funding with member donors.

Deepening poverty outreach. CGAP remains committed to improving the capacity of microfinance providers to increase their poverty outreach. As part this work, CGAP will continue to promote transparency on the poverty levels of clients, disseminating practical tools to the industry such as the donor Poverty Assessment Tool and the Poverty Audit. We will also document and disseminate field-level success in reaching very poor and vulnerable groups.

Measuring social performance. CGAP wishes to achieve positive social impact to complement the financial impact of microfinance. To this end, CGAP will work to help the industry measure social and development performance. Building on work others have done in this area, CGAP will help develop a limited number of simple indicators linked to the MDGs. Microfinance institutions will be encouraged to report on this set of social performance indicators in the MIX and to donors. They will be reported on periodically by CGAP.

Improving Information Quality and Availability

Transparency within a financial system ensures that customers and providers of capital can reliably assess risk and return, and that auditors and supervisors can oversee the system's safety. For financial service providers to the poor to reach significant numbers, they need to be able to intermediate between domestic savers and borrowers, as donor funds have neither sufficient scale nor stability to support massive growth. One of the key challenges to the development and integration of financial services for the poor is the lack of reliable information on the financial strength and performance of different types of service providers. Poor people's deposits and commercial loans should be available only to financial institutions with accurate, complete, and comparable information on their financial strength and performance. Such information underpins the development of the market for these financial services, raising the quality and lowering the cost of supervision, audits, and ratings, and enabling commercial and private funding.

To compete effectively, institutions also need to know about their own performance and where they stand in relation to others, either within peer groups or on a global basis. Information about an MFI's own performance enhances managers' ability and interest in improving performance. The incentive to improve increases when managers and outsiders can compare an institution's results against the performance of others, or against agreed standards and/or supervisory requirements, and determine where adjustments are needed.

There are many other contexts requiring transparency in microfinance besides transparency on financial performance. These include transparency on client poverty levels, customer credit histories, the cost of borrowing, and on MFIs' social performance. CGAP's agenda under information quality will focus on financial transparency, while transparency on social performance is treated under the agenda on promoting financial services to a broad range of clients.

Building the information infrastructure. CGAP's comparative advantage in this area stems both from its history of improving the quality and quantity of information on the performance of microfinance service providers and from its role as a consortium of donors who support microfinance. These efforts will remain a cornerstone of CGAP's transparency work as CGAP continues to build the information infrastructure needed by financial institutions, donors, private investors, government regulators, and the public at large to understand and judge the performance of the industry. CGAP will continue to promote the availability of information on the performance of microfinance providers, as well as to bridge the information gap between supply (funders) and demand (microfinance service providers).

Much of CGAP's work in this area will be integrated under a single information service, the Microfinance Information Exchange (MIX).

Developing financial reporting standards. The paucity of accurate data on the financial performance of institutions providing financial services to the poor highlights the need to place greater emphasis on financial monitoring and reporting using standardized ratios and reporting formats. At the forefront of CGAP's strategy is the development of technical tools and standards to improve the quality and quantity of information on the performance of MFIs. Prime among these efforts are the development of a streamlined format for reporting financial information by microfinance service providers and the harmonization of financial ratios.

Building local expertise. Building the local expertise to analyze, collect, and report MFI financial information is a key priority. To this end, CGAP will work in collaboration with local microfinance networks, technical consultants, and others to develop types of training materials for MFI managers, bank regulators and supervisors, and auditors and evaluators working in microfinance. In most cases, these will need to be complemented by on-the-ground technical support provided by our partners. CGAP will also work with universities, training institutes, and other learning institutions to mainstream microfinance knowledge and skills into their curriculum and programs, both to improve public understanding of microfinance and to build a local supply of skilled, dedicated microfinance professionals.

Fostering a Sound Policy and Legal Framework

As new solutions are found for the delivery of financial products and services to the poor, and as these systems become more integrated in the overall financial system, policy and legal frameworks will need to adapt so that governments can play their appropriate role as facilitators, rather than direct providers of financial services for the poor. CGAP's goals in this area will be to:

- Foster diversity of institutions and financial pro ducts through a policy and legal regime that gives them equal treatment and is not biased in favor of one institutional model or product;
- Establish a supportive legal and regulatory framework that safeguards poor people's money and promotes competition; and
- Develop the technical expertise of government supervisory and regulatory authorities.

CGAP is in a strong position to support the development of a sound legal and regulatory environment for microfinance. Our comparative advantage in this area stems from our neutrality, our multi-donor platform, our relationship with the World Bank, the IMF and regional development banks, and the leverage that these organizations have in addressing policy issues with government policymakers. In Phase III, CGAP will capitalize on these comparative advantages much more than it has in the past, working with and through its member donors to improve the policy and regulatory framework for financial services to the poor. Greater emphasis on policy will mean additional staff resources but will not have significant non-salary budget implications.

Engaging in multilateral policy consultations. CGAP will continue to engage more systematically in policy consultations with the World Bank, the IMF, and other international financial organizations. Inputs will be provided to key policy processes such as Country Assistance Strategies and Financial Sector Assessment Programs (in coordination with the Financial Sector of the World Bank) to help national authorities design better policies to promote financial services for the poor. CGAP will also selectively participate in other types of high-level policy fora that offer direct opportunities to influence real policy change.

Supporting country-level policy dialogue. Upon specific request, CGAP will also engage in country-level policy consultations to educate policymakers about the importance of financial services to the poor and the range of international experience in this sector. In certain countries, it will also support the development of policy frameworks such as Poverty Reduction Strategies to mainstream financial services in national approaches to private sector development. CGAP's approach will be to support the country-level work of CG members in alliances with key government policymakers and the private sector. In general, priority will be given to policy work that concretely contributes to the establishment of appropriate enabling environments or has the potential to pre-empt the establishment of policies or programs that would adversely affect the development of the sector in a particular country.

Facilitating development of policy and regulatory standards. CGAP's role as an international and multi-donor organization makes it uniquely placed to provide a platform where all stakeholders – donors, central banks and other regulatory bodies, and microfinance practitioners – can discuss and develop global and industry-wide standards and guidelines for microfinance. A model for this role may be the Basel Committee for Banking Supervision. The objective would be to encourage convergence towards common approaches and standards in policy, regulation, and supervision.

Developing technical tools, services, and training. At a technical level, CGAP will continue to develop technical tools and knowledge for those who play a policy, regulatory and supervisory role in microfinance. Wherever possible, these will be developed in partnership with other providers. Complementing this work, CGAP and its partners will develop and deliver training courses for government policymakers, bank regulators and supervisors, and donor staff on legal and regulatory issues in microfinance. These courses may range from short high-level sensitization sessions delivered to central bankers and senior officials through the IMF, the World Bank and other such bodies, to longer technical courses for bank supervisors on specific tools and approaches for analyzing the soundness of MFIs.

THE ROLE OF DONORS

The Challenge for Donors

Donor funds have played a crucial role in supporting microfinance over the past two decades and donors remain the most important external source of funding for microfinance experimentation. However, the reality is that a significant proportion of donor funding is ineffective, narrowly targeted to a few countries and institutions, or poorly structured – languishing, for example, in apex facilities with inappropriate conditionality, application, and reporting requirements.

The evolution of microfinance towards a broader, diverse set of institutions and mechanisms integrated into the financial sector poses even greater challenges to donor effectiveness. Each agency and the donor community collectively must answer a number of key questions:

- How do financial services for the poor fit into each donor's development strategy?
- What is the appropriate role of subsidy?
- How much risk can an agency tolerate?
- When should microfinance be used and when are other instruments more appropriate?
- How can disbursement pressure be avoided or diminished?
- How flexible are the available instruments?
- Does staff have sufficient expertise to design effective programs in this area?
- Are internal processes, procedures, and practices consistent with sound practices?

Donors can improve their effectiveness in microfinance by addressing these questions head on. Further, donors should identify their comparative advantage compared to one another and to more commercial sources of funds. Some donors may find their best role in capacity building, while others may establish a niche in expanding the financial frontier in, for instance, remote rural areas.

One thing is certain: the latest vision of microfinance will require significant innovation, experimentation, and human resource development. It will also need funding, but probably less for capitalization of loan funds and more for technical assistance than was previously the case. New institutions entering the field will already have their own funding sources and some of the newer services – such as deposits – will not need to be funded. Donors will continue to be important players in microfinance, but in a much more leveraged and strategic way than in the past.

Specifically, donors should take more risks on promising but not yet proven institutions and mechanisms, leaving the more commercially viable MFIs to graduate to private investors. They should adjust their country-level programming approach to also facilitate funding of global or multi-country microfinance networks and other intermediaries. And they should support industry-wide measures that promote transparency and build critical infrastructure such as performance standards and the application of technology to financial services for the poor.

The donor community can play a catalytic role in bringing about the next revolution in financial systems for the poor. Their careful, strategic use of subsidies could push microfinance over the threshold into the new era of financial services, where poor people are widely accepted as legitimate customers within a diverse, deep, and multi-faceted financial sector.

Donors can play an important role in building financial systems that work for the poor by addressing those challenges in a pro-active way and committing to the following actions:

Develop strategic clarity. Donors should develop a clear and coherent strategy for microfinance that is consistent with their own development agendas while remaining true to accepted good practices. For instance, it is not uncommon for staff to view microfinance as an input into agricultural development, a tool for empowerment, or a way to deepen the financial sector – all within the same agency. Each of these approaches has very different implications for whether good practices will be applied at the operational level. Donors need to clarify how microfinance can fit into their institution's major priorities for growth and poverty alleviation as a cross-cutting issue and how it forms an integral part of the financial sector.

Intensify collaboration. The international development community is moving toward more collaborative approaches, for instance by concentrating on the Millennium Development Goals and focusing on the work of the Development Assistance Committee of the OECD. Better collaboration and cooperation in microfinance, both globally and at the country level, will improve each donor's capacity to adhere to mutually agreed standards. It will also help donors to avoid undermining each other or inadvertently squelching the engagement of the private sector in supporting financial systems for the poor.

Improve understanding on the role of subsidies. There is an important need for greater clarity on the role donor subsidies in supporting financial services for the poor. When is it appropriate to use subsidies? For how long? At what point should public sector support be phased out? When should the private sector take over? Donors need to work towards reaching consensus on when and how subsidies should be used to support microfinance and when other instruments would be more appropriate. This crucial question will be part of the process of defining each donor's comparative advantage, both with respect to each other and the private sector.

Support innovation. Donors should take risks by working with smaller, less well-known but promising institutions of all kinds that have the potential to provide financial services to the poor in cost-effective ways. Donors can contribute to product diversification and innovation by offering grants or subsidies on a limited basis to institutions that develop or test new products or technologies, or that attempt expansion into difficult "frontier" markets like remote rural areas. Special efforts should go toward encouraging MFIs that develop savings-based products.

Ensure accountability for results. Donors should commit to disclose the size and composition of their microfinance portfolio, the performance of the institutions they support, and whether or not their agencies conform with recognized good microfinance practices. Donors can also promote the development of a culture of transparency by requiring that the institutions they support publicly disclose financial, social, and depth of outreach information and by employing performance-based funding instruments.

Introduce appropriate instruments. The development of financial systems that truly address the needs of the poor will require the application of flexible instruments for research and development, capacity-building, and initial operational subsidies. These instruments should target appropriate, professional implementing partners, have a long-term time horizon, and include performance-based funding mechanisms. In addition, donors should promote global or multi-country initiatives that promote transparency and build support infrastructure, such as local technical service providers, improved technology, and performance standards.

Establish a focal unit for microfinance. In many agencies, microfinance operations are scattered in different departments such as infrastructure, food security, or community development, and can be difficult to track. Donors committed to pursuing microfinance should establish a focal unit with strong technical expertise and authority to provide proper review and quality control of all proposed microfinance activities. The focal unit would also engage in mainstreaming good practices among non-microfinance specialists in their agency.

Build staff skills. Experience shows that donors with higher levels of staff technical competence in microfinance more consistently produce programs that adhere to good practices. This correlation between staff skills and sound practice persists even when most project development and implementation work is contracted out. Donors should commit to investing in the staff skills needed to design and supervise microfinance operations effectively. Staff should have a broad range of skills and experience in promoting financial services for the poor through different types of institutions, including NGOs, commercial banks, credit unions, finance companies, postal savings banks, or insurance companies.

How can CGAP support Donors?

CGAP will intensify its work with member donors to address the challenges faced by them. Specifically, CGAP will work with member donors to improve the effectiveness, efficiency, and accountability of their operations in microfinance by: (i) building on and catalyzing a sense of urgency and commitment to better microfinance programming; (ii) supporting donor agencies to promote organizational changes within their agencies required to apply good practices in microfinance; and (iii) encouraging mutual support and cross-learning among donor agencies. To accomplish this goal, CGAP will offer responsive, high-quality services to its donor members in the areas of standards building, information dissemination, training, and technical assistance.

CGAP understands that change must emanate from within the donor agencies themselves and cannot be driven by the CGAP Secretariat. For this reason, CGAP can best leverage its limited resources by working through a committed focal point within each donor agency. Moreover, to maximize efficiency, CGAP will emphasize those tools and services that can be used by multiple agencies.

That said, CGAP recognizes the diversity among its member donor agencies. Different agencies require very different support, and different people within each agency have different informational needs. CGAP also recognizes the fact that the majority of staff manage wide-ranging portfolios with limited time and resources directed specifically to microfinance. Where committed focal points are in place, CGAP will focus on providing tailored and timely support, services, and information according to the needs of different staff and managers within donor agencies.

CGAP will pursue several different methods for increasing interaction with member donors and enhancing its understanding of their support needs. First, the Donor Peer Reviews currently underway and continuing throughout the early phase of CGAP III will provide many new opportunities for the Secretariat to support member donors. Second, the establishment of an office in Paris will greatly facilitate interaction between CGAP and European donors, as well as among European-based donors. Third, CGAP will intensify the relationship manager function and introduce a new donor staff Helpdesk to respond to donor staff in a more agile manner, both within and outside of the technical focal unit. Fourth, a permanent position will be established in Washington for short-term member donor staff rotations at the Secretariat.

Facilitating donor interaction. Reflecting the essence of its mission, CGAP will exploit every opportunity to facilitate information flows and collaboration among its donor agencies. This work will reach beyond annual CG meetings to encompass more intensive work on specialized topics of interest to them, both through formal Working Groups and other mechanisms such as listserve discussions or videoconferences. Also, CGAP will move forward on supporting selected in-country donor coordination (ICDC) groups with technical and information services.

Developing operational guidelines. CGAP will work with member donors to develop operational guidelines to address a range of issues facing donors, such as how to support savings mobilization; when to withdraw support to poorly performing institutions; how to properly sequence subsidies, grants, loans and other instruments; when to support apex institutions; and when to support multi-sectoral programs. These operational guidelines would build on the Peer Reviews and other opportunities for joint learning and would likely launch a process resulting in a new version of the Pink Book.

Developing technical tools and providing just-in-time information. Based on improved knowledge of donor needs, CGAP will build upon its information dissemination capacity and technology platforms to develop timely relevant technical tools, services, and information products appropriate for donor staff. Information will be packaged in formats and delivery channels that different types of donor staff can use and will address several key issues, such as understanding microfinance in the broader context of development, advancing diverse financial services, supporting diverse institutions, the impact of microfinance on the poor, and developing sound programming and operations. Concrete, concise case studies and models of good donor practices will comprise an important component of these information services.

Building staff skills. Evidence suggests that staff capacity in microfinance is a strong determinant of effective donor operations. CGAP will place increased emphasis on building donor staff skills both at headquarters and field office levels. CGAP will continue to offer training services to donor agencies with an increased focus on non-microfinance specialists, both at management levels and among operational staff. This training will be provided to groups of donor staff, but CGAP will also explore leveraging its resources by partnering with in-house training units with a view toward strengthening their own microfinance training capacity and, in the long term, their ability to meet internal demand.

Tailored technical assistance. On a selective basis, CGAP will offer direct technical assistance to individual donor agencies where it affords the most leverage and has the most potential for impact. This assistance will include the following services: assisting in the implementation of recommendations of the Peer Reviews; reviewing project or policy documents; and facilitating internal workshops or strategy sessions.

RESOURCES

Implementation and Organization

The strategic priorities outlined for Phase III will be reflected and incorporated in the organizational structure and operations of the CGAP Secretariat. The Secretariat will selectively expand its staff as recommended by the evaluation team to enable it to meet the needs of CGAP's new and expanded agenda. In particular, top talent will need to be acquired with expertise in the broader range of financial products (e.g. savings) and financial institutions (i.e. cooperatives) encompassed by the new vision. Additional senior staff will also be necessary in the policy area. In all cases and consistent with the rest of CGAP's strategy, diversity will be a key driver in our human resources CGAP will thus continue to aim to attract and recruit exceptionally talented individuals of diverse expertise, backgrounds, and views.

The CGAP Secretariat will remain housed at the World Bank with its headquarters in Washington, DC, and a representative office focusing on donor work in Paris, France. Individual Secretariat staff may be located elsewhere, such as in donor agency offices in the field, or in CGAP capacity building hubs, as may be justified by business opportunities. Additional offices for CGAP in the field are not envisaged at this time, but may be considered by management and the Board in the future. A permanent position will be established in Washington, DC, for short-term member donor staff exchanges.

In line with these priorities, the technical work of the Secretariat will be organized along five teams, four of which are already in place:

Microfinance Industry Team/Transparency. The scope of the Microfinance Industry Team's work includes the broad transparency agenda and global-level activities aimed at improving the quality and quantity of information on microfinance providers. It also includes the exchange of industry knowledge and information through web-based services such as the Microfinance Gateway.

End-Client Team/Diversity of Products and Services. The objective of the End-Client Team is to deepen understanding of the financial needs of the poor and their access to existing financial services, to improve the capacity of institutions to deliver a broad range of financial services to the poor, and to ensure greater depth and breadth of outreach by exploring diverse approaches and models.

Financial Institutions Team/Diversity of Institutions. The purpose of the Financial Institutions Team is to explore alternative means of delivering financial services to the poor, primarily through action research on different models and support of innovation through strategic funding in conjunction with member donors (e.g. Appraisal and Monitoring Service). The focus of the team will be significantly broadened to a more diverse range of financial institutions.

Policy Team. To enable CGAP to play the role sought by its member donors and other stakeholders in policy work, a small team dedicated to policy and regulatory issues will be created in the near future. This team will focus on working with multilateral organizations and supporting in-country donors and other technical people to help sensitize governments and create supportive legal and regulatory environments for microfinance.

Donor Team. The recent creation of a Donor Team within the CGAP Secretariat underscores the importance of donor support as a core CGAP activity. The objective of the Donor Team is to work with member donors to improve the effectiveness, efficiency, and accountability of their operations in microfinance through standards building, information, training, and technical assistance services.

NOTES

CGAP
c/o The World Bank
1818 H Street, N.W.
Room Q4-400
Washington, D.C. 20433